In the Supreme Court of the United States

OCTOBER TERM, 1950

No. 392

SAM SCHNITZER, MONTE L. WOLF, ADMINISTRATOR DE BONIS NON, ETC., ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 28-70),[1] reviewed *en banc*, is reported in 13 T. C. 43. The opinion of the Court of Appeals (R. 562) is reported in 183 F. 2d 70.[2]

[1] Record references are to the record in *Sam Schnitzer* v. *Commissioner*, unless otherwise noted.

[2] The *per curiam* opinion of the court below contained in the record (R. 562) incorrectly cites the opinion of the Tax Court in this case as being reported in "12 T.C. 483". This was corrected in the court below on August 4, 1950, to read "13 T.C. 43", and the latter citation is also correctly shown in the Federal Reporter (183 F. 2d 70).

JURISDICTION

The above entitled six cases were consolidated for trial in the Tax Court (R. 548), and were by order of the court below consolidated in that court for the purposes of printing the record on appeal, briefing, argument, and decision (R. 547-549). In each case the judgment of the Court of Appeals was entered on July 24, 1950, and timely petitions for rehearing were denied on September 25, 1950.[3] The petition for a writ of certiorari was filed on October 30, 1950. The jurisdiction of this Court is invoked under the provisions of 28 U.S.C., Section 1254.

QUESTION PRESENTED

The Alaska Junk Company, Portland, Ore., a partnership consisting of two men and their wives, made large advances of funds and material to Oregon Electric Steel Rolling Mills, a corporation, virtually two-thirds of the issued stock of which was owned by the partners. The question presented is:

Whether the Tax Court could properly infer from all of the evidence adduced that the advances so made by the partnership constituted capital contributions by the partners and not loans, so that losses aggregating $202,350 sustained by the partners as a result of the advances were not deductible pro rata for income tax purposes during the year

---

[3] Sam Schnitzer, R. 563, 564; Estate of Harry J. Wolf, R. 51, 52; Monte L. Wolf, R. 55, 56; Blossom M. Goldstein, R. 57, 58; Charlotte C. Cohon, R. 57, 58; Estate of Jennie Wolf, R. 51, 52.

1943 as bad debts within the meaning of Section 23 (k) (1) of the Internal Revenue Code.

STATUTE INVOLVED

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(k) [As amended by Section 124 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798, and Section 113 (a) of the Revenue Act of 1943, c. 63, 58 Stat. 21] BAD DEBTS.—

(1) *General Rule.*—Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. This paragraph shall not apply in the case of a taxpayer, other than a bank, as defined in section 104, with respect to a debt evidenced by a security as defined in paragraph (3) of this subsection. This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a non-business debt, as defined in paragraph (4) of this subsection.

* * * * *

(26 U.S.C. 1946 ed., Sec. 23.)

INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statute involved	3
Statement	4
Argument	19
Conclusion	25

CITATIONS

Cases:

Arnold v. *Phillips*, 117 F. 2d 497, certiorari denied, 313 U. S. 583	23
Balestrieri, Joe, & Co. v. *Commissioner*, 177 F. 2d 867	21
Boehm v. *Commissioner*, 326 U. S. 287, rehearing denied, 326 U. S. 811	24
Brown-Rogers-Dixson Co. v. *Commissioner*, 122 F. 2d 347	24
Cohen v. *Commissioner*, 148 F. 2d 336	20
Commissioner v. *Culbertson*, 337 U. S. 733	20
Deputy v. *duPont*, 308 U. S. 488	24
Equitable Society v. *Commissioner*, 321 U. S. 560	24
Gillette's Estate v. *Commissioner*, 182 F. 2d 1010	22
Grace Bros. v. *Commissioner*, 173 F. 2d 170	21
Greenfeld v. *Commissioner*, 165 F. 2d 318	21
Kelley, John, Co. v. *Commissioner*, 326 U. S. 521	20, 23
New Colonial Co. v. *Helvering*, 292 U. S. 435	24
1432 Broadway Corp. v. *Commissioner*, 4 T.C. 1158, affirmed, 160 F. 2d 885	23
Pacific Southwest R. Co. v. *Commissioner*, 128 F. 2d 815, certiorari denied, 317 U. S. 663	24
United States v. *Gypsum Co.*, 333 U. S. 364, rehearing denied, 333 U. S. 869	21, 22
United States v. *Real Estate Boards*, 339 U. S. 485	22
United States v. *Yellow Cab Co.*, 338 U. S. 338	22

Statute:

Internal Revenue Code:

Sec. 22 (26 U.S.C. 1946 ed., Sec. 22)	20
Sec. 23 (26 U.S.C. 1946 ed., Sec. 23)	3
Sec. 117 (26 U.S.C. 1946 ed., Sec. 117)	19
Sec. 1141 (26 U.S.C. 1946 ed., Supp. II, Sec. 1141)	20

Miscellaneous:

Federal Rules of Civil Procedure, Rule 52	20, 22
Treasury Regulations 111, Sec. 29.22 (a)-16	20

STATEMENT

The primary facts, other than certain categorical statements by petitioners' witnesses with respect to the intent of the parties, are not in dispute. As found by the Tax Court (R. 29-53) those relevant here may be stated as follows:

During the years 1942 and 1943 Sam Schnitzer and Harry J. Wolf were active in the operation of the Alaska Junk Company (hereinafter called Alaska Junk), a partnership engaged in the business of buying, selling, and generally dealing in junk, pipe, tools, machinery, hardware, scrap, and other metal products at Portland. The books of Alaska Junk were kept on an accrual basis and partnership returns, prepared on that basis, were filed for that firm in 1942 and 1943 with the Collector of Internal Revenue for the District of Oregon. On these returns Sam Schnitzer and his wife, Rose Schnitzer, and Harry J. Wolf, and his wife, Jennie Wolf, were listed as partners, and a share of profits was reported as distributable to each. (R. 33-34.)

In January, 1928, Sam Schnitzer and Harry J. Wolf, who had for many years, without formal agreement, carried on business in Portland, Oregon, under the name of Alaska Junk Company and Schnitzer-Wolf Machinery Company, entered into a written agreement whereby each transferred to his wife a one-fourth interest in the business, the husbands to carry on the business as theretofore.

The Alaska Junk Company (hereinafter sometimes referred to as "Alaska Junk") was then duly recorded as a partnership, composed of four individuals, H. J. Wolf, Mrs. J. Wolf, S. Schnitzer, and Mrs. R. Schnitzer, each owning a one-fourth interest therein. (R. 35-36.)

As Alaska Junk expanded its activities and grew in financial strength, it occasionally made loans or advances to customers in the expectation of maintaining or increasing its trade. These advances, which ranged from small amounts to $8,000, were made sometimes when the customer was indebted to it for goods and were charged to his open account. Most of these advances were repaid by cash or by credit for scrap supplied. Some were not repaid. (R. 38-39.)

Alaska Junk also made very large advances to enterprises in which members of the Wolf and Schnitzer families were interested. Schnitzer's son, Morris, individually operated a scrap business under the assumed name of Schnitzer Steel Products Company. Between July 1936 and March 1948 Alaska Junk made to him cash advances aggregating $119,020.99, of which $17,517.37 was repaid in cash and the rest in scrap. In 1939 Wolf and Schnitzer and their wives organized the Central Supply Company as a wholesale dealer in plumbing and electric goods. The organizers, in payment for its capital stock, placed $50,000 to its credit in an account with Alaska Junk, and Alaska Junk

thereafter made to it aggregate cash advances of $15,500, and also sold it goods. Charges to the account were paid. In 1939 Wolf, Schnitzer, and their wives and Morris Schnitzer incorporated Industrial Air Products Company for the manufacture of oxygen and acetylene. Alaska Junk was charged with the amount of the stock subscription. Thereafter it made cash advances aggregating $94,427.03, and it sold merchandise to the company. Repayment was made. In 1940 Wolf, Schnitzer, and their wives and one Shea organized the Plumbing & Heating Sales Company. Alaska Junk advanced the money for its capital and made sales to it and purchases from it. In 1941 Alaska Junk and Dulien Steel Products Company formed the Carlton Coast Railroad Liquidators as a joint venture to acquire and dismantle a logging camp and railroad and to sell the salvaged materials. Alaska Junk advanced $27,525 for the venture and acquired a 50 per cent participation, and it received $134,649.94 from it. The partnership kept open accounts with all the persons and firms to whom the above mentioned advances were made, charging to such accounts all cash advanced and merchandise furnished, and crediting them with payments in cash or in goods bought by it. (R. 39-40.)

On June 4, 1941, Morris Schnitzer, son of Sam Schnitzer, organized the Oregon Electric Steel Rolling Mills (hereinafter sometimes called Oregon Steel) as an Oregon corporation with an authorized

capital of $250,000, represented by 2,500 shares of stock of a par value of $100 each. Of the authorized shares, subscription was made for 1,878 shares as follows: Morris Schnitzer 1,250[4] shares, Sam Schnitzer and Harry J. Wolf 312½ shares each and Bernard Levin and Louis Schnitzer 1 share each (R. 40). On June 12, 1941, 1 share was issued to each of the five subscribers; on August 4, 1 share was issued to L. N. Rosenbaum; and on February 10, 1942, 1,251 shares were issued to Morris Schnitzer, 312½ to Sam Schnitzer, and 312½ to Harry J. Wolf. On February 10, 1942 Sam Schnitzer and Wolf surrendered their 312½ share certificates and 4 new certificates for 156¼ shares each were issued to each of them and their wives. There were also changes in the holders of one share. (R. 41.)

Oregon Steel was organized to erect and operate a rolling mill for the manufacture of steel products. Its stockholders planned to melt down and use scrap metal, which in 1941 was being sold in Portland at $1.50 to $2 a ton less than in Seattle, and on the basis of engineers' production estimates they expected the earnings eventually to reach $50,000 or more a month. Morris Schnitzer, with whom the idea originated, was made president and general manager. He was active in seeking capital for Oregon Steel, in getting engineering advice and trade information, and in procuring materials and the necessary priorities. Sam Schnitzer, the vice

---

[4] Apparently 1251 shares (see R. 41, 186).

president, and Harry J. Wolf, the secretary, also rendered services. The corporation's board of directors was composed of Morris, Sam and Rose Schnitzer, and Harry J. and Jennie Wolf. None of them had any experience in steel production. (R. 41-42.)

From October 1941 Alaska Junk made numerous advances of cash to Oregon Steel, supplied it with goods of various kinds at cost, and paid bills for it. Morris Schnitzer likewise advanced cash, paid bills, and supplied goods, and these amounts, together with the expenses of his business trips, were charged to the corporation's account with Schnitzer Steel Products Company. Nearly all of the advances were for plant and equipment, but after operations began $9,460 in scrap was furnished by Alaska Junk. All of the foregoing items were charged to the corporation's open accounts with Alaska Junk and Schnitzer Steel Products Company, respectively. On November 30, 1942, the corporation's account with Alaska Junk showed a debit balance of $299,069.70 and its account with Schnitzer Steel Products Company, a debit balance of $138,984.11. On an office memorandum Sam Schnitzer referred to these advances as "contributed capital." (R. 42-43.)

During 1941 Morris Schnitzer made numerous attempts to procure outside capital. In June he besought New York investment banking houses to make a public offering of Oregon Steel's stock, but

they declined on the grounds that no proper engineering reports had been submitted and that the organizers lacked adequate experience. The Commercial Credit Corporation refused to make a loan because they deemed the $250,000 authorized capital too small. For the same reasons the Bank of America refused a loan in November 1941. The Bank of Portland refused a loan in April 1942, despite oral assurances by the corporation's officers that $1,000,000 would be invested in the plant and more would be available for working capital. In October 1941 the corporation filed application with the Reconstruction Finance Corporation for a loan of $600,000 and employed the engineering firm of MacDonald Bros., Inc., to make a survey and report on the necessary investment and probable operating costs. On this application Morris Schnitzer, signing as president, stated that the corporation proposed to expend $550,000 of the proceeds on building and equipment and $50,000 on raw materials, brick, manganese, scrap, etc. He estimated that the plant would cost $890,000, and stated that capital was then $187,700, but added: "We expect to increase the capital of this corporation shortly. Additional stock will be taken by S. Schnitzer and J. Wolf to equal that of M. Schnitzer." On the MacDonlad report, filed with the RFC on November 10, 1941, cost of the mill and equipment was put at $987,035, exclusive of engineering, legal, traveling, and organization expenses.

Organization expenses were given as $65,000. (R. 43-44.)

The RFC was not satisfied with the MacDonald report, and a second was submitted from another engineer, who estimated that the mill would cost $1,050,000. On April 2, 1942, the executive committee of the RFC approved the loan, subject to listed conditions. After several changes had been made in the conditions, Sam Schnitzer and Wolf, as partners of Alaska Junk, wrote RFC on December 1, 1942, that cost of the mill might exceed $1,200,000 and that Alaska Junk would furnish any necessary money in excess thereof to complete the project if RFC would lend an additional $100,000. On December 4, 1942, RFC approved a loan of $700,000, having received assurance that there had been no change in the borrower's financial condition and business prospects. Oregon Steel gave to the Federal Reserve Bank of San Francisco its 4 per cent promissory note for that amount, dated December 15, 1942, payable within 5 years by monthly installments of $6,500 from May 1, 1943, and by an additional annual payment sufficient to make all payments equal to 50 per cent of the corporation's net earnings for the preceding year. The note was secured by a duly recorded mortgage on the corporation's real estate and the plant to be constructed and equipped and on its personal property with the exception of cash, receivables, raw materials, and inventories. Effective supervisory powers

were given to RFC to enforce current compliance with the terms. (R. 44-45.)

By separate agreement Morris, Sam and Rose Schnitzer, and Harry J. and Jennie Wolf individually guaranteed repayment of the note and bound themselves to supply "additional working capital" in amounts deemed satisfactory by RFC as long as any part of the loan should remain unpaid. The corporation bound itself to limit officers' annual salaries for such period to a total of $25,000, and to pay in cash no more than $15,000. In an instrument of December 29, 1941, the corporation, Morris Schnitzer, and Alaska Junk recited that Morris Schnitzer and Alaska Junk had already contributed $138,984.11 and $299,069.70, respectively, in the form of cash or property to the corporation; that (R. 45):

> * * * Such contributions by stockholders have, as stated, been as a capital investment, and in no wise as outstanding accounts payable by Borrower, except to the extent that Borrower's debenture notes may be issued for a part of such contributions or capital investment.

The stockholders further agreed that they would receive in payment of "all such capital investments so made" only the common stock or debenture notes of the corporation and the corporation in turn covenanted to make payments in no other way. The corporation further agreed that, as long as

any part of the RFC loan should remain unpaid, it would not issue to stockholders any preferred stock or evidence of indebtedness except debentures on a prescribed form "in return for advances made or to be made by them." The prescribed form forbade payment of principal or interest on the debentures until full repayment of the RFC loan. These conditions were observed, but RFC did allow reimbursement for about $114,519 of subsequent advances for the purchase of mill equipment. (R. 45-46.)

While the final terms of the RFC loan were being arranged, Wolf expressed dissatisfaction because Morris Schnitzer, holding two-thirds of the corporate stock, had not made a proportionate part of the advances. Costs of the enterprise had already exceeded anticipations, and Morris was financially unable to advance more. The stockholders entered into negotiations among themselves for a more satisfactory distribution of interests. They reached an agreement, and pursuant thereto the corporate directors authorized issuance of debenture bonds for $250,000 on terms contemplated by the understanding with RFC. On January 12, 1943, it issued such bonds in an aggregate of $249,000 to its stockholders (R. 46).[5] These bonds bore 8 per cent interest and were payable within 10 years of issue, but no payment of interest or principal

[5] The bonds were issued as follows (R. 46): Morris Schnitzer $75,000, Sam Schnitzer $44,000, Rose Schnitzer $43,000, Harry J. Wolf $44,000, and Jennie Wolf $43,000.

could be made while any balance remained due on the corporation's $700,000 note to R. F. C. (R. 47.)

As part of the settlement agreement Morris Schnitzer on March 11, 1943, surrendered 626 of his 1,251 shares of stock. One share was reissued to Monte L. Wolf and the remainder to Sam Schnitzer and wife and Harry J. Wolf and wife, so that the corporation's 1,878 outstanding shares were thereafter held as follows: Morris Schnitzer 625 shares, Sam Schnitzer, Rose Schnitzer, Harry J. Wolf, and Jennie Wolf 312½ shares each, and Monte Wolf 1 share. (R. 47.)

By entries of March 31, 1943, the corporation charged the open account of Schnitzer Steel Products Company (Morris Schnitzer) with $75,000 for "debentures issued" and with $62,500 "to offset bal. of stock subscriptions due against Acc. Pay.," leaving a credit balance of $6,638.23 in the account. By entries of the same date it charged Alaska Junk's open account with $174,000 "to record debentures issued" and with $124,900 "to offset bal. of stock subscriptions due against Acc. Pay.," leaving a balance of $315,095.41 in that account. By entries of July 14, 1943, Alaska Junk credited the corporation's account by corresponding amounts, specifying that the shares and bonds had been issued to Sam and Rose Schnitzer and to Harry J. and Jennie Wolf in the amounts above set forth. No other shares were ever issued, although

in the beginning the organizers had expected to issue more to associate promoters. (R. 47-48.)

In connection with the bond issue and stock transfer Morris Schnitzer orally agreed with Sam and Rose Schnitzer and Harry J. and Jennie Wolf that he would bear one-third of any loss that might result from the total amounts advanced and to be advanced by all five to the corporation, over and above the advances credited to stock subscriptions. They in turn agreed to bear two-thirds of any such loss. Morris Schnitzer and Alaska Junk continued thereafter to make advances, as before, and these advances were credited to their open accounts with the corporation in the same way as before and charged to the corporation's open accounts with them. (R. 48.)

In asking for larger releases of the authorized loan, Morris Schnitzer on March 18, 1943, wrote RFC that costs were rising and that the stockholders had "in this job over $700,000 of our own money," but "never originally intended to put in over * * * the $500,000 we were supposed to put in as our share of the capital investment." In a prior letter of December 23, 1942, he had referred to "additional costs for the extensions and additions" to the plant, suggested in the McKee report to increase production capacity, and requested approval of them. (R. 48-49.)

Construction work on the mill began in November, 1942, but building materials were hard to ob-

tain; new machinery was scarce; priorities could not be procured for some requirements; and second-hand equipment and materials had to be used in part. Prices steadily increased. The mill was finally completed in June 1943 at a cost of $1,400,000, and the melting of scrap into ingot started soon thereafter. About the same time Morris Schnitzer entered the military service, and his brother, Manuel Schnitzer, who had been employed by the corporation since the preceding January, took charge. Manuel was not familiar with steel manufacture; two engineers, successively engaged as managers, proved unsatisfactory; and competent personnel and operators were difficult to find. Manuel made vigorous efforts, however, and rolling operations were begun late in August. But the machinery did not function properly; production was so far behind schedule that many large orders were canceled by customers, principally the United States Government; creditors pressed for the payment of bills; there was a lack of ready cash, and a serious financial crisis developed. In June 1943 the corporation began to get some relatively small loans from banks, secured by its steel inventory and warehouse receipts for scrap. By November 26 these amounted to $149,499.71. (R. 49.)

The stockholders again tried unsuccessfully to interest outsiders to take a participating interest, and approached the United States Steel Company, Bethlehem Steel Company, Republic Steel Com-

pany, Henry Kaiser, and others. But in November 1943 they ceased operations, and on November 26 they decided to withdraw from the enterprise entirely and to sell all their shares to Kenneth E. Hall and A. M. Mears for one cent a share. Before so doing, they had the corporation give to Schnitzer Steel Products Company its promissory note for $26,829.28 and to Alaska Junk its promissory note for $427,843.87. The amounts of these notes were equal to the respective credit balances shown on that date in the payees' open accounts with the corporation, but as later computed such balances were in fact $26,493.77 and $428,132.13, respectively. (R. 49-50.) That of Alaska Junk reflected the following aggregate debits and credits (R. 50):

Debits		Credits	
Cash advanced	$327,870.23	Stock	$124,900.00
Bills paid	166,340.16	Bonds	174,000.00
Goods furnished	347,341.62	Repayments	114,519.88
Total	$841,552.01	Total	$413,419.88

Immediately after the sale the purchasers elected new officers and directors, Mears becoming president. Pursuant to a resolution of the new directors and with the consent of the RFC, the corporation gave to Morris, Sam and Rose Schnitzer, and Harry J. and Jennie Wolf its 6 per cent note for $249,000, payable in annual installments of $24,900 beginning June 1, 1954, and secured by a second mortgage on the corporation's property. It also gave to them its 6 per cent note for $151,000, payable in annual installments of $15,100 beginning June 1, 1954, and secured by a third mortgage on

its property. In consideration of these notes the payees surrendered to the corporation the debenture bonds for $249,000 and the newly made promissory notes for $26,829.28 and $427,843.87. (R. 51.)

By accepting the $151,000 note in exchange for the two newly made promissory notes, the five former stockholders of Oregon Steel failed to recover $303,625.90 of the total shown due from the corporation for their advances on open account, which at the time showed credit balances aggregating $454,625.90. Pursuant to his agreement, Morris Schnitzer made reimbursement to the other four in the amount of $83,581.20 in order to reduce their loss to two-thirds of the total. This settlement was effected by a charge of that amount to Morris on the books of Alaska Junk and by his later delivery of second mortgage notes on account thereof to Alaska Junk. (R. 51.) The charge of $83,581.20 was explained in the journal as follows (R. 51-52):

> To charge Morris Schnitzer with 1/3 of total loss in steel mill deal. Total investment and a/c of A. J. Co. 727,032.13; total of Morris Schnitzer 163,993.77 or 891,325.90 for both—Total payment by mrtge 400,000. Total loss 491,325.90. Morris' share of loss 1/3 or 163,775.30. His investment and a/c of 163,993.77 less his interest in two mtge notes of $83,799.67 results in loss of 80,194.10 on the amount he expended plus 83,581.20 due us.

Alaska Junk then charged off $202,350.60 on its accounts with the corporation as a bad debt. (R. 52.)